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TAGS: ECON EFIN HR
SUBJECT: CROATIAN BANKS ARE STABLE, FOR THE MOMENT

¶1. Summary: Croatia's economy and banking system remain reasonably stable, although not entirely immune to the effects of the world financial crisis. The central bank has temporarily removed a restrictive reserve requirement on Croatian banks that draw credit from abroad. The government also announced it will increase deposit insurance from 100,000 kuna (14,000 euro) to 400,000 kuna (56,000 euro). The Croatian National Bank (HNB) claims this amount covers 90 percent of deposits in Croatia. The banking sector, although largely foreign-owned, has shown few signs of true crisis. Croatian banks have benefited from a restrictive monetary policy that has limited credit exposure abroad. Nevertheless, there is clear unease in the press, which tracks almost daily the woes of Croatian banks' European parent institutions. Croatia also has a large foreign debt and current account deficit, which represent significant risks. Flows of foreign direct investment, which had been adequate to cover the deficit, are forecast to decline.

¶2. Summary continued: The main Zagreb stock market index, the Crobex, has also been volatile. The index lost 30 percent of its value last week, only to rebound significantly early this week. It then fell again 8 percent on October 15, due partly to a press report linking Raiffeisenbank (Austrian bank with a large presence in Croatia) to financial institutions in Iceland. The true level of consumer confidence in the economy and the banking sector remains unclear, but sales of big ticket items, such as new cars, are already hurting in the uncertain climate. Overall, officials and experts with whom we spoke agree Croatia is withstanding the crisis as well as can be expected, but that the economy remains vulnerable. End summary.

Banks Foreign-Owned, but Insulated

¶3. Approximately 90 percent of Croatia's banking sector is foreign-owned, mostly by other large European financial institutions. All the parent banks of Croatia's major banks have experienced large drops in share prices this year. Italian UniCredit (owner of Zagrebacka Banka) and Intesa SanPaolo (owner of Privredna Banka) have experienced drops of 48 percent and 69 percent, respectively. These two banks comprise approximately 50 percent of the Croatian banking sector. Austrian Raiffeisenbank (owner of a Croatian subsidiary of the same name) has seen a 53 percent drop in its share price so far this year. There have been no major signs of mass withdrawals by Croatian depositors, although there were briefly long queues at Zagrebacka Banka two weeks ago after the press reported widely on UniCredit's difficulties.

¶4. Despite foreign ownership, Croatian banks enjoy significant structural and regulatory advantages. First, local banks are distinct legal entities and are capitalized domestically, largely through deposits rather than lines of credit from other banks. In 2006, the HNB imposed a restrictive 55 percent reserve requirement on capital raised from abroad. This "tax" discouraged most banks from

borrowing abroad and has correspondingly limited their exposure to risk. (NOTE: This reserve requirement has recently been removed temporarily in an effort to increase liquidity in the capital markets). The HNB has also maintained a strict credit expansion ceiling introduced last year. According to the EBRD Director for Croatia, the HNB's policies have been prescient in limiting risk to Croatia's banks, while encouraging them to build a strong domestic deposit base. However, one of President Mesic's economic advisors told us he remains unconvinced that these advantages will prove sufficient should the situation continue to deteriorate for the European parent banks.

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Foreign Debt and Current Account Deficits Worrisome
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¶5. Both Croatian officials and international financial institution representatives have told us that Croatia's foreign debt, currently 95 percent of GDP, is a large area of concern. In the new environment of tight credit markets, the EBRD believes the government will be forced to shift its borrowing needs to the domestic market. Domestic credit will be more expensive, but will reduce exposure to financial shocks from abroad. However, private corporations and households account for a much greater share of the foreign debt, around 50 percent. According to the World Bank, this could increase the speed and magnitude by which financial turbulence in Europe could transmit to Croatia.

¶6. Croatia's current account deficit also remains high, at 8.6 percent of GDP. This could be problematic, since the government has relied on significant foreign direct

investment (largely through big ticket privatizations) to cover the deficit. These FDI inflows are likely to shrink since there are few major government assets left to sell. Shipyards are a large asset the government plans to privatize next year, but the success of the sale is both politically and financially uncertain. Without FDI to cover the deficit, the government will have to rely on further borrowing in a very unfavorable credit market.

¶7. Another critical source of foreign currency inflow is the tourism industry, accounting for over 20 percent of GDP. The president of the Croatian Association of Hotel Operators told the press that tourism will be among the industries hardest hit by the global financial crisis. Indeed, unofficial data indicate an effect already, recording a 9 percent drop in the number of tourists for September 2008 as compared to 2007.

¶8. A lower availability of credit for companies and individuals will force adjustments in personal expenditures and limit new business enterprises. Coupled with higher than expected inflation this year, the Croatian consumer could see some hard times ahead. The EBRD has correspondingly adjusted its 2008 GDP growth forecast for Croatia from 6 percent to 3,8 percent. The World Bank forecasts 4.5 percent growth.

¶9. COMMENT: The unknown factor is Croatians' true level of confidence in the banking sector. Given the financial history of the country, Croatians have more reason than most to be skittish depositors and investors. The collapse of Ljubljanska Banka after the breakup of Yugoslavia wiped out many Croatians' savings and legal proceedings to recover them continue to this day. Croatians also remember the high current account deficits of the late nineties, which in 1998 precipitated a severe banking crisis followed by a recession. Consumer confidence is probably not aided by the press, which reports dire warnings of imminent European bank collapse one day, followed quickly by euphoric headlines when the stock market rebounds. A story on October 15 describing supposed ties between Raiffeisenbank and financial institutions in Iceland appears to have led to a rapid 6

percent decline in the Crobex. For these reasons, the government's increase in deposit insurance is a logical, and probably effective, first step. But it is clearly too early to say the Croatian economy is out of danger from turbulence in the European financial markets.
Bradtke